

Disruption to the cable industry from the new rate rules has already been alleviated by extending the effective date of the rules from June 21st to September, over two months. Any disruption resulting from moving up the effective date to September 1st will be ameliorated by the Commission decision to extend its preemption of federal and local notification requirements. This would allow operators to make rate changes up to September 1st, as they would under the current scheme. It would also give operators additional time during the start-up phase to file their rate schedules on Form 393 with either local government or FCC.

The FCC will continue to exert every effort to administer the Cable Act consistent with Congressional intent.

Chairman Quello also emphasized today that consumers have not been informed that the rate freeze effective April 1st will have saved consumers between \$122 and \$200 million according to Paul Kagan Associates, Inc. Research. This was based on projections in Kagan's 1992 financial data book and on the consumer price index. Paul Kagan is a leading independent researcher of the cable industry.

**Exhibit D**

ERNEST F. HOLLINGS, SOUTH CAROLINA, CHAIRMAN

DANIEL K. INOUE, HAWAII  
WENDELL H. FORD, KENTUCKY  
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JUDG GREGG, NEW HAMPSHIRE

KEVIN G. CURTIN, CHIEF COUNSEL AND STAFF DIRECTOR  
JONATHAN CHAMBERS, REPUBLICAN STAFF DIRECTOR

## United States Senate

COMMITTEE ON COMMERCE, SCIENCE,  
AND TRANSPORTATION

WASHINGTON, DC 20510-8125

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June 16, 1993

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The Honorable James H. Quello  
Interim Chairman  
Federal Communications Commission  
1919 M Street, N.W.  
Washington, D.C. 20554

Dear Chairman Quello:

Although I have tremendous sympathies for the resource problems at the Federal Communications Commission, I find it totally inexcusable that the Commission has delayed implementation of cable rate regulation in a manner that will significantly diminish the rate relief that consumers should receive under the Cable Act passed by Congress last year. I do not understand why extension of the June 21, 1993 implementation date and delaying the availability of complaint forms are related to the Commission's resource problems. While it may take longer to process complaints and certify cities than originally expected, these delays should in no way expunge consumers' rights for full rate relief once the Commission has determined that rates are unreasonable. I ask the Commission to carry out the intent of the law passed by Congress and ensure that consumers may obtain refunds for basic rates from June 21, 1993, and that consumers have the ability to file complaints for other cable programming services any date after June 21, 1993.

Again, I understand that the Commission's resource problems are severe and I will do whatever I can to increase the Commission's funding. I do not believe, however, that this resource shortfall should disadvantage consumers. I urge you to remedy this problem as soon possible.

Sincerely,

  
DANIEL K. INOUE  
U.S. Senator

**Exhibit E**

EDWARD J. MARKEY, MASSACHUSETTS, CHAIRMAN

W.J. "BILLY" TAUZIN, LOUISIANA  
 RICK BOUCHER, VIRGINIA  
 THOMAS J. MANTON, NEW YORK  
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 ARJONIE MARGOLIES-MEZVINSKY,  
 PENNSYLVANIA  
 MIKE SYNAR, OKLAHOMA  
 RON WYDEN, OREGON  
 RALPH M. HALL, TEXAS  
 BILL RICHARDSON, NEW MEXICO  
 JIM SLATTERY, KANSAS  
 JOHN BRYANT, TEXAS  
 JIM COOPER, TENNESSEE  
 JOHN D. DINGELL, MICHIGAN  
 (EX OFFICIO)

JACK FIELDS, TEXAS  
 THOMAS J. BILEY, JR., VIRGINIA  
 MICHAEL G. OXLEY, OHIO  
 DAN SCHAEFER, COLORADO  
 JOE BARTON, TEXAS  
 ALEX MCMEILLAN, NORTH CAROLINA  
 J. DENNIS HASTERT, ILLINOIS  
 PAUL E. GILLMOR, OHIO  
 CARLOS J. MOORHEAD,  
 CALIFORNIA (EX OFFICIO)

**U.S. House of Representatives****Committee on Energy and Commerce****SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE****Washington, DC 20515-6119**

July 7, 1993

ROOM H2-318  
 FORD HOUSE OFFICE BUILDING  
 PHONE (202) 226-2424

DAVID H. MOULTON  
 CHIEF COUNSEL AND STAFF DIRECTOR

*DLA  
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*on 7/2/93  
 2807*

The Honorable James H. Quello  
 Acting Chairman  
 Federal Communications Commission  
 1919 M Street, N.W.  
 Washington, D.C. 20554

Dear Chairman Quello:

I am very concerned about reports that the Commission intends to use October 1, 1993 as the effective date for implementation of rate regulations pursuant to the 1992 Cable Act. I strongly urge the Commission to reconsider the timetable for taking action on this critical section of such importance to American consumers.

While I am sympathetic to the Commission's administrative concerns and requirements, the Commission should not make the public wait any longer to see the \$1 billion in savings they were promised by the Commission in April. Consumers have already lost a significant portion of these potential savings, they can not afford to lose any more. The continued delay until October will cost consumers an estimated \$250 million.

On Friday, President Clinton approved an increase of \$11.5 million to the Commission's 1993 budget so that implementation of the rate regulations could begin immediately. With the necessary funding now approved, the meter for savings to the consumers should begin ticking as soon as possible and the Commission can begin to deal with any administrative concerns on a reasonable timetable.


For this reason, the Commission should set August 1, 1993, as the effective date for the regulations. The effective date is critically important to preserving the promised savings for consumers because any refunds or rate rollbacks will be tied to this date. In this way, the Commission can assure consumers that relief is in sight while concomitantly beginning the logistical implementation of rate regulation as soon as possible.

You will recall that during the Subcommittee's June 17, 1993, oversight hearing on the implementation of the 1992 Cable Act, the Commission agreed to respond within days of the President's approval of a supplemental appropriation as to its adjusted timetable to begin to regulate cable rates. Now that

The Honorable James H. Quello  
July 7, 1993  
Page 2

this additional funding has been approved, I look forward to the Commission providing me with its adjusted timetable by Friday, July 9. If you have any questions about this matter, please contact Kristan Van Hook of my Subcommittee staff at (202) 226-2424.

Sincerely,

  
Edward J. Markey  
Chairman

**Exhibit F**

## Federal Communications Commission Record

### Separate Statement of Chairman James H. Quello

**In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992 (Rate Regulation), MM Docket No. 92-266.**

This is a difficult decision.

If I were free to set the effective date of rate regulation based solely on what makes the most sense from an administrative standpoint, I would have let the October 1 date stand. But I do not have such freedom. I am required to balance all the factors facing the Commission; the enormity of the task and the potential for massive disruption of service must be weighed against the congressional desire that the date be moved, and against the prospect that failure to heed Conference Report language could have lead to additional budget cuts for the Commission.

I am committed to the complete and orderly implementation of the Cable Act in this year, as well as the next. Perhaps more importantly, I believe it is vital to uphold the integrity of the Commission, and to push forward on the many other statutory responsibilities with which we are charged. Accordingly, I chose not to gamble with the FCC's future by retaining the October 1 effective date.

The suggestions made by some that the Commission's actions regarding the effective date reflect a reluctance to implement that 1992 Cable Act are astonishing and ridiculous. The staff of this agency has labored around the clock since the Act's passage to produce the record number of difficult rules mandated by Congress. No one could seriously suggest that the Commission has deviated from the statutory design to unfairly favor the cable industry. At all times, the Commission has endeavored to follow congressional will, as expressed both before and since the passage of the Act.

The reasons the Commission changed the effective date in the first place have been thoroughly discussed elsewhere and I will not repeat them. See, e.g., *Congressional Record*, July 1, 1993 at H4472-73 (Statement of Chairman John D. Dingell). But considering all the factors

described above, the Commission is following the most responsible course.

Part of being responsible includes today's denial of Consumer Federation of America's *Emergency Petition for Immediate Implementation of Emergency Rule Permitting Immediate Rate Regulation*.<sup>1</sup> CFA proposed that the Commission issue an order authorizing cable subscribers to unilaterally withhold 15 percent of their next cable bills. Excessive withholdings would then be subject to Commission orders requiring the subscribers to reimburse the cable operators. Granting this petition would have completely disrupted the Commission's implementation plan and would have promoted chaos for the industry and consumers. The petition appeared to be more of an effort to grab headlines and to engage in self-aggrandizement than a serious plan for rate regulation.

The Consumer Federation of America's proposal would harm consumers because of the confusion it would create and because it would freeze the Commission's processes to a far greater extent than any plan that may have been suggested by the cable industry. But it underscores that organization's pathological disregard for the real world implications of its suggestions. For example, shortly after the Commission extended the effective date to October 1, CFA's legislative director called my office and angrily demanded that all FCC personnel be pulled off other duties to stuff envelopes so that rate regulation could be implemented immediately. When informed that this would mean halting work on important policy matters, such as video dial tone and PCS, among other issues, he replied, "I don't care."

Of course, no responsible policymaker could seriously consider such demands. And, fortunately, the Commission did not. This agency has a statutory obligation to regulate communications industries for the benefit of all the public, and is not obliged to accede to the demands of groups who, despite their pretensions, have not been appointed the bargaining agents for all consumers.

This is not to say that the Commission has been unaffected by our new regulatory responsibilities. All of our other statutory missions have suffered. But through a conscious effort to apply rational management techniques, we have been able to move forward. On July 22,



for example, President Clinton praised the Commission for its recent actions to promote new technologies including PCS.

Accordingly, I believe that the Commission's actions on the effective date for rate regulation, including denial of the CFA petition, serve the larger public interest embodied in the Communications Act.

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<sup>1</sup>CFA was joined by Media Access Project, Public Citizen and the Center for Media Education. Some among these groups have some familiarity with the Commission and should have known better than to sign on to such a transparently unrealistic proposal.

**Exhibit G**

which helps the States establish scholarships. For each Federal dollar, the States provide at least \$1. No Federal funds have yet been obligated for fiscal 1993, but students in many States have been notified that they were to receive awards. As a result of the conference report, 242,000 students will not have their grants reduced.

The bill also provides \$13.7 million for the cooperative education program, which enables institutions of higher learning to participate in work-learning programs. These students spend a semester working on the job in their chosen fields during their course of study. It is an integral part of their education. I am pleased that these funds have been restored.

The bill also provides \$3.8 million for college library and technology cooperation grants, which help college libraries purchase computers and other technologies that enable them to improve their efficiency and infrastructure.

In addition, the bill provides \$341 million for the Pell grant shortfall, more than twice the amount originally passed by the House. Unfortunately, the shortfall stands at more than \$2 billion. But combined with amounts approved by the House in 1994 appropriations, Pell grant recipients should be encouraged that Congress is moving in the right direction, in the face of harsh budget realities.

The bill also contains an additional \$170 million for the summer jobs program. This funding will provide 120,000 new summer jobs for our Nation's youth.

I thank the Appropriations Committee for its hard work.

Mr. GOODLING. Mr. Speaker, I would like to take this opportunity to comment on provisions affecting programs under the jurisdiction of the Education and Labor Committee in the conference report on H.R. 2118, a bill making supplemental appropriations for fiscal year

the inclusion of a provision which expands the eligibility for this program to individuals up to age 30. In effect, this continues to make a substantive change to a program under the Job Training Partnership Act—a change made not by the authorizing committee, the Education and Labor Committee; and not really by the Appropriations Committee; but by the House Rules Committee just prior to the original floor consideration of H.R. 2244. While this measure was approved in conference, these actions set a dangerous precedent—that of authorizing on an appropriations bill—when the authorizing committee had no input whatsoever.

The Youth Fair Chance Program was carefully crafted to serve economically disadvantaged youth in areas of high poverty. The language in the agreement would expand and potentially diminish services to high-risk youth once this program is up and running. Quite simply, we do not know what the consequences of the change made in the agreement will be.

Mr. DINGELL. Mr. Speaker, I see in support of the conference report to accompany the bill H.R. 2118, making supplemental appropriations for fiscal year 1993. However, I would like the RECORD to reflect my concern with the portion of the statement of managers that concerns the Federal Communications Commission's implementation of the 1992 Cable Act.

The conferees have stipulated that the Commission should revise their current schedule so that cable consumers will be able to receive refunds no later than September 1. Now I have enormous sympathy for cable subscribers—they've been getting ripped off for years, which is one of the reasons that we passed the Cable Act over the veto of then-President Bush. But the Commission has repeatedly told the Congress that it cannot responsibly imple-

ment that could take years to unravel. This judgment is shared by each conferee.

There are four reasons why we have found that cable rate regulation cannot be implemented prior to October 1. Briefly stated, these are:

(1) A statutory prerequisite to regulation of rates for the basic tier is the FCC's certification of local franchising authority's jurisdiction to regulate these rates. Absent staff to process the expected challenges to these thousands of certification requests and to issue "stop" orders where appropriate, any certification request submitted will automatically become effective 30 days after receipt. This result would be inconsistent with due process and is certainly not contemplated by either the statute or the legislative history.

(2) Even if franchising authority certification were not a problem, any attempt to determine rates and order refunds prior to October 1 would still be premature. Notwithstanding our adoption of benchmarks on April 1, a number of open issues on implementing rate regulation remain to be resolved. On this basis, we cannot say that it will be possible to rationally determine what basic rates should be and what refunds would be in order prior to October 1. As of May 14, when the Commission did not delay the effective date of the rate regulations beyond June 21, we did not fully realize the extent of our implementation challenge. Commissioner Barrett noted his concern regarding the implementation issues. Since that time, we have all agreed that the complexity of cable rate implementation makes it essential that we take more time until October 1.

(3) Recognizing these problems, franchising authorities ranging from small cities in Iowa to New York City have affirmatively welcomed the delay, especially since basic rates will remain frozen in the interim. In other words, they will not be ready to do rate regulation or order refunds prior to October 1. We would further note that the freeze on basic

DAVID S. DUGGEN,  
Commissioner.

I would remind my colleagues—and the members of the Federal Communications Commission—that admonitions such as this are not binding law. Nor are they welcome from the Appropriations Committee, which does not have jurisdiction to revise or rewrite legislative policy or regulatory decisions. It is my hope that the Commission continue on its current course, and implement the law in a manner that is fair to cable subscribers, local government officials, and to the Commission itself.

Mr. KYL. Mr. Speaker, I rise today to address an issue that has caused a great deal of fear, a great deal of misinformation, and a great deal of concern among the people of Arizona. The issue is the unexplained respiratory distress syndrome which has already taken 16 lives. As of today, there are 29 known cases of the illness.

Mr. Speaker, I have had conversations with the leadership of the Navajo Nation and officials of the Indian Health Services. I know how concerned people are and how hard they are working to develop a good medical response.

In the meantime, it is also important to dispel some myths. The facts are, Mr. Speaker, that it is not unsafe to visit Navajo country or any other of our reservations. The facts are that this is not an illness that affects one people or another. There is no evidence at this time of person-to-person transmission, and contagiousness appears to be low.

I am told that Federal, State, local, and tribal health officials have worked in concert to come up with answers. Together, these officials have made significant progress and have identified the Hantaan virus, which can be spread through rodent urine and excrement, as a possible cause of the disease. Additional tests are being conducted by the Centers for Disease Control. Interviews conducted by Navajo community health workers, and the State health departments are disseminating information on the facts about the disease and what precautions should be taken.

tee to credit worthy borrowers. That simply is not true. Anyone who believes that the SBA loan guarantee program is not critically needed should talk with those small businesses which have sought help under this program.

Even though prospective borrowers were told their applications would be put on hold indefinitely pending passage of a supplemental appropriation, they continue to come. They continued to complete the necessary documentation and put their spending plans on hold.

SBA estimates that it has a backlog of more than \$1.1 billion in loan guarantee requests from 5,000 small businesses. These are viable firms who have nowhere else to turn.

Mr. Speaker, I want to congratulate the chairman of the appropriations subcommittee which provides funding for the SBA, Representative NEAL SMITH of Iowa, and the other Members who worked with him to find the funds to reopen this vital program.

This is a jobs program. It creates jobs. It preserves jobs. It will help us with our economic recovery. Based upon a study done in the private sector last year, the 7(a) loan guarantee money provided in this bill will allow the small business sector to provide 33,820 jobs in the first year and a total of 134,400 jobs over the next 4 years.

If other programs were as successful and contributed as much per capita to our economy, we would be reducing the deficit.

I urge support for the conference report.

Ms. MCINNEY. Mr. Speaker, I am speaking on behalf of the rural water and sewage treatment facilities direct loan program. This program targets aid to smaller and poorer communities and helps those communities obtain cleaner water and improved waste disposal systems.

For far too long small rural communities have been placed at a disadvantage when trying to obtain Federal assistance to construct rural water and sewage facilities.

This program will help smaller and poorer communities comply with Federal regulations. Many times these communities find themselves unable to comply with Federal regula-

tions for fiscal year 1993 by the House was \$1 billion below the ceiling for defense contained in the budget resolution for fiscal year 1993.

Senate action on this supplemental basically provided funds for the same purposes as the house but offset these expenses by rescissions.

The conference agreement, in summary, provides funding of \$1.3 billion. Of this total, 75 percent, or almost \$1 billion, is offset through rescissions.

These funds are for the same purposes provided in the House-passed version of the supplemental plus a few additional items including humanitarian aid for the Kurds and extending the availability of defense conversion funds which were about to expire.

The conference agreement includes an increase of \$500 million in transfer authority to assist the Defense Department in addressing its internal fiscal year 1993 reprogramming efforts only.

Mr. Speaker, I recommend support of this supplemental bill.

Mr. BEREUTER. Mr. Speaker, this Member appreciates the Senate's provision, included in this conference report, that reverse the very unfortunate decision of the House Appropriations Committee to have \$136 million in rescissions for 14 education programs, including the Cooperative Education Program and the State Student Incentive Grant Program.

This Member earlier attempted to offer an amendment to the House second supplemental bill to restore the \$13,749,000 for the Cooperative Education Program that was rescinded by the House Appropriations Committee, but failed to get unanimous consent to successfully accomplish a cut-and-add transfer of funds within the bill to accomplish this purpose. Therefore, this Member is pleased to see this funding for these essential education programs restored by the conference committee.

Mr. MCDADE. Mr. Speaker, I yield back the balance of my time.

Mr. NATCHER. Mr. Speaker, I yield

**Exhibit H**

## **DECLARATION**

**I, William Shew, hereby declare under penalty of perjury that the following statements are true and correct:**

**I am Director of Economic Studies, Arthur Andersen Economic Consulting. I have engaged in numerous studies of the economics of cable systems and television markets in the United States and Europe. My curriculum vitae is attached.**

**I have been asked to examine the foundation of the benchmarks proposed by the FCC to regulate the prices of basic cable services, particularly as those benchmarks apply to small cable systems, defined as having fewer than 1000 subscribers. The benchmarks are intended to describe the prices that "competitive" cable television systems would charge for basic cable service packages. The FCC recognized that the prices a cable system charges -- whether "competitive" or not -- depend on characteristics of the service it provides. Its schedule of competitive benchmarks is a function of (1) the number of system subscribers, (2) the number of channels available on all regulated tiers, and (3) the number of satellite delivered channels on all regulated tiers. The FCC plans to prohibit any "non-competitive" cable system from charging service prices higher than the benchmark prices that, according to its analysis, a "competitive" cable system would charge in the same circumstances.**

**My conclusions concerning the statistical validity and the soundness of the benchmarks can be summarized as follows:**

1. There are inaccuracies in the FCC data used to develop the benchmarks. Determining how these inaccuracies have affected the benchmarks would be quite difficult.
2. The FCC's sample of small competitive systems is quite small, with the result that the benchmarks derived by the FCC are characterized by a significant degree of uncertainty.
3. A number of the systems used to develop "competitive" benchmarks are municipal systems or private systems engaged in price wars, whose prices would tend to understate the prices that are sustainable in long-run competition.
4. The FCC benchmark equation does not adequately predict the prices charged by small, competitive cable systems.

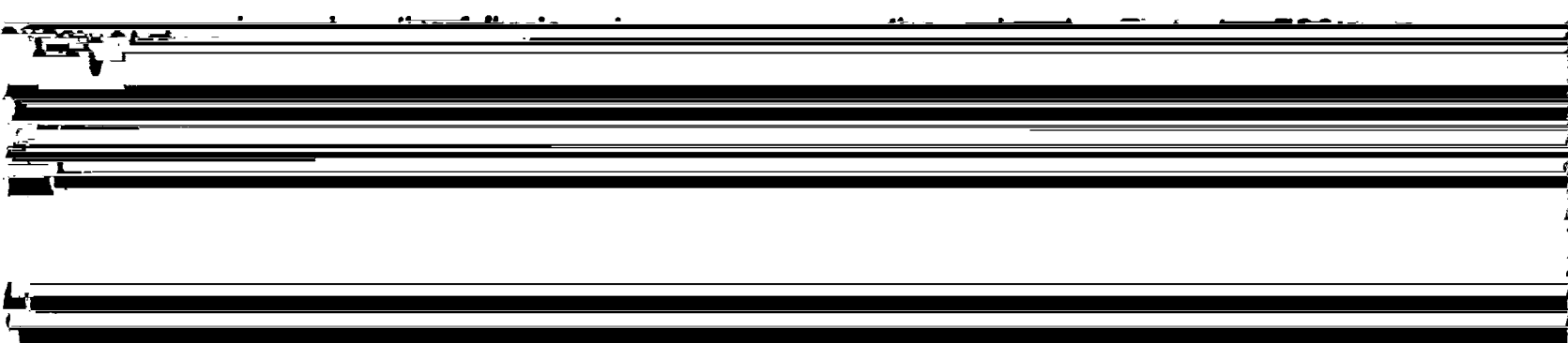
I will begin by summarizing how the FCC constructed its benchmarks, which is necessary to understand their infirmities. I will then explain my reservations about the benchmarks.

### Benchmark Construction

To develop its competitive benchmarks, the FCC began by sending a questionnaire to systems serving 748 cable franchises, out of a total of approximately 30,000 cable franchises operating in the U.S.. Of the 748 surveyed franchises, 300 were randomly selected. The remainder consisted of at least one franchise belonging to each of the largest 100 cable systems and franchises where the FCC believed that "effective" competition was taking place. Cable systems were asked to report what basic cable service packages they provided, how many channels were supplied on each service and the price that was charged, as of September 30, 1992. They were also asked to report the number of subscribers to each service, and various other information.

Much of the information requested by the FCC is specific to individual franchise areas served by the selected cable systems. Quite commonly, a single cable television system serves adjacent communities or areas that, from the perspective of local franchising authorities, consist of separate franchises. That a cable operator's service territory may consist of several contiguous franchises is normally irrelevant to the operations of a cable system. The operator customarily provides the same set of service options throughout the service area, charging a price for each that does not vary from one franchise to another. But since "competition", as defined by the FCC, can sometimes be present in one of a cable system's franchise areas and not others, the basic unit of observation in the database developed by the FCC is the cable franchise. For each of the sampled cable systems, the FCC requested information on the "primary" franchise and, if the system's service territory consisted of more than one franchise, a second franchise. A system's "primary" franchise was defined by the FCC as the franchise drawn in the sample. The "secondary" franchise was to be chosen to favor examples of effective competition, different channel line-up or prices, and large subscriber size. Of the 687 systems returning valid questionnaires, 267 reported on only a primary franchise and 420 reported on a primary and secondary franchise.

After compiling the data reported by the surveyed cable systems, the FCC then selected a subset of the responses, which it used to develop the competitive benchmarks. Although the details of this winnowing process remain





The benchmarks themselves are expressed in terms of the average price per channel a cable system would be allowed to charge for basic cable services. Many cable systems offer two or more basic service packages, often referred to as tiers. In such instances, the basic service prices charged by a cable operator would be tested by comparing its subscriber-weighted average price per channel to the benchmark price for systems having its attributes. In the example below, the weighted average price per channel is 82.9¢, according to the FCC formula, which involves dividing the subscriber-weighted average price by the subscriber-weighted number of channels. The subscriber-weighted price is \$11.60 ( $10 \times \frac{500}{500} + 8 \times \frac{100}{500} = 11.6$ ) and the subscriber-weighted number of channels is 14 ( $10 \times \frac{500}{500} + 20 \times \frac{100}{500} = 14$ ), which gives 82.9¢ ( $\frac{\$11.60}{14} = 82.9\text{¢}$ ).

<u>Tier</u>	<u>Price</u>	<u>Subscribers</u>	<u>Channels</u>
Basic	\$10	500	10
Expanded Basic	\$8	100	20

Using the sub-sample of the cable system franchises it selected, the FCC developed its benchmarks by estimating an equation relating the average price per channel charged by a cable system in a franchise area, calculated in this fashion, to four factors: (1) system subscribers, (2) number of channels available in all regulated tiers, (3) number of satellite delivered channels in all regulated tiers, and (4) whether effective competition exists in the franchise. The resulting equation was then translated by the FCC into a series of tables displaying the benchmark price as a function of attributes of cable systems. Examples of FCC benchmarks are displayed in the following table.

**Benchmark Price/Channel, 200 Subscribers**

<u>Satellite Channels</u>	<u>Total Basic Channels</u>		
	<u>12</u>	<u>24</u>	<u>50</u>
6	\$1.436	\$0.776	\$0.404
16	—	\$0.856	\$0.446
30	—	—	\$0.476

**Benchmark Price/Channel, 800 Subscribers**

<u>Satellite Channels</u>	<u>Total Basic Channels</u>		
	<u>12</u>	<u>24</u>	<u>50</u>
6	\$1.397	\$0.755	\$0.393
16	—	\$0.833	\$0.434
30	—	—	\$0.463

**Benchmark Evaluation**

For benchmark prices to be reasonable, they must allow the cable systems regulated by them an opportunity to recover the cost of providing cable service, including the cost of capital. If benchmarks prevent a number of cable systems from recovering their costs, the long-term consequence will be a withdrawal of service from those areas, something not in the interest of consumers.

To evaluate whether benchmarks are likely to provide systems with the opportunity to recover their costs, it is helpful to address the following questions.

1. Are the data used to construct the benchmarks accurate?
2. Are the service prices charged by the "competitive" systems in the sample adequate for those cable systems to recover their costs?
3. Is the sample of competitive systems sufficiently large to produce a statistically reliable measure of "competitive" prices?
4. Do the benchmarks take into account all of affecting service costs that would be necessary to prevent the benchmark prices from falling below service costs for some cable systems?

It is true that, in the new regulatory environment, a cable system feeling that the benchmark applicable to it is unreasonably low would be afforded the opportunity of justifying its prices by reference to its cost of service. Thus, it might appear that the reasonableness of the benchmark prices should not be of great concern. But that overlooks the consideration that many cable systems, especially small ones, frequently do not have the detailed cost records, extending back in time, that firms accustomed to cost-based rate regulation are in the practice of keeping. Even those small systems that have maintained and preserved the necessary cost records would have to prepare whatever analyses are required to implement the methodology that is adopted to estimate service costs. The burden that would be imposed on such systems of developing a cost-of-service justification makes it quite important that a system of benchmark regulation establish reasonable price caps.

I will now turn to a discussion of what I see as some of the deficiencies of the FCC benchmarks.

## **1. Inaccurate Data**

The portrayal of service prices, subscriber numbers and channel carriage contained in the FCC's database is not always accurate. That is clear from spot checks performed under my direction and also from a comparison of the FCC database with a "corrected" version of the database prepared by the National Cable Television Association. It would be very laborious to develop a systematic evaluation of the error rates in the FCC database, the average size of the errors, and the effect of those errors on the benchmarks calculated by the FCC. Although such an evaluation would be quite useful, I am not aware that anyone has undertaken it.

In its absence, all that can be said is that errors in the FCC data may have produced inappropriate benchmarks.

## **2. Small Sample Size**

Of the 377 franchises used to develop the benchmarks, the overwhelming share are "non-competitive", according the FCC's classification scheme. They would have had only a minor effect on the statistical derivation of "competitive" benchmarks -- as indeed should be the case, given the objective of obtaining a benchmark that describes the cable service prices that emerge in competitive markets.

The FCC designated three tests to determine whether a franchise is characterized by "competitive" prices. Cable service qualified as "competitive" if it satisfied any of those conditions, which the FCC characterizes as categories A, B, and C.

**Category A:** Service penetration in the franchise area is no greater than 30%

**Category B:** Competing systems serve the franchise<sup>1</sup>

**Category C:** The franchise contains a municipal cable system<sup>2</sup>

For brevity, I will refer to these criteria of competition as, respectively, 30% penetration, overbuilds, and municipal systems.

The equation used by the FCC to generate the benchmarks is estimated from a sample containing only 45 small "competitive" cable systems — not a terribly large number to provide a firm foundation for regulating the prices charged by every small system in the country. Within the group of small competitive systems, there are only two representatives of systems having between 500 and 750 subscribers, and only five with between 750 and 1000. There are various ways of quantifying the imprecision small sample size introduces in the development of competitive benchmarks. One useful measure relates to the variable in the FCC's equation characterizing whether or not a service is "competitive".

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<sup>1</sup> More precisely, to qualify as competitive by this test, a rival system must cover 50% of the franchise and obtain a penetration rate above 15%.

<sup>2</sup> More precisely, the "franchise authority" must offer a video programming service that is available in over 50% of the franchise area.

**Table 1: Small Systems in the FCC Sample**

System Subscribers	Not Competitive	Competitive			Category Total
		30% Penetration	Private Overbuilds	Municipal Markets	
0 to 50	4	5	0	1	10
50 to 100	5	7	0	0	12
100 to 250	19	7	4	1	31
250 to 500	25	9	0	4	38
500 to 750	15	1	1	0	17
750 to 1000	9	3	2	0	14
<b>TOTAL</b>	<b>77</b>	<b>32</b>	<b>7</b>	<b>6</b>	<b>122</b>

According to the FCC's analysis, service prices are 9% lower in "competitive" franchises, other factors equal. In other words, if two systems have identical numbers of subscribers and channels, but one operates in a "competitive" franchise and the other does not, the FCC would predict that service prices in the competitive franchise would be 9% lower. But in actuality, that estimate is subject to some uncertainty, which can be quantified. The probability is 95% that franchise competition reduces prices somewhere between 3.5% and 14.1%. In calculating its benchmarks, the FCC has assumed that competition uniformly reduces service prices by 9%, which is close to the midpoint of this interval. But we can be 95% sure only that the "correct" benchmark prices are somewhere between 3.5% and 14.1% below the prices charged in systems classified as non-competitive.

Even the figure of 45 almost certainly overstates the number of cable systems in the database capable of providing a reliable guide to "competitive"

prices. Six of the small cable systems qualify as competitive because they are municipally owned or compete with a municipal cable system. But in those markets, prices may well be below the cost of a private sector operator, because municipal cable services have unique cost advantages. In addition, six of the seven private overbuilds involving small systems have existed five years or less (five of these have been competing less than four years). Such short-term competition is typically characterized by price wars, during which prices are held below average total cost. If the short-term overbuilds (lasting five years or less) and markets involving municipal systems are removed, the FCC sample contains only 33 small "competitive" cable franchises.

#### **Small Systems with Competitive Franchises**

<u>Competition Criteria</u>	<b>FCC Data</b>	<b>Clean FCC Data</b>
30% Penetration	32	32
Private Overbuilds	7	1
Municipal Franchises	6	0
Total	45	33

### **3. Inappropriate Choice of Benchmark Systems**

Markets involving municipal cable systems and short-term overbuilds cannot be expected to provide a reliable guide to the prices that characterize sustainable competition between private cable systems. A municipal cable system has cost advantages unavailable to private cable systems, including access to inexpensive finance (tax exempt bonds), use of public rights-of-way at no charge, and exemption from franchise fees and property taxes. These considerations would lead to the expectation that prices charged by municipal

systems tend to be lower than the prices charged by competing private cable systems.

That does indeed seem to be true of the cable systems in the FCC database. The "competition" variable in the FCC's benchmark equation indicates whether the system qualifies as being classified as competitive by any of the three FCC tests (30% penetration, private overbuild, municipal system). We replaced that single variable in the analysis by separate variables indicating whether or not the system (a) had a penetration rate of 30% or less, (b) was involved in a private overbuild, or (c) was a municipal system. With that reformulation, we re-estimated the FCC equation. The results revealed that basic service prices charged by municipal systems are almost 15% below prices charged by competing private systems, other factors equal.

It is also questionable whether some of the prices charged by competing private systems provide a suitable basis for developing benchmark prices. Cable overbuilds almost invariably precipitate price wars far more drastic than the price competition that occurs in most markets. The reason is not hard to find. The fixed costs of providing cable service are quite high, consisting essentially of the distribution system. Once those costs are incurred, the variable cost of serving subscribers is relatively low. When cable systems compete head-to-head, each has an incentive to drop its price as low as the variable cost of service, a low figure, if the alternative is to lose subscribers to the rival cable system.

As a case in point, one of the overbuild cable systems in the FCC database is charging \$1.85 for its second tier, which contains 26 satellite-



transmitted channels of programming. We determined the channel line-up (the FCC did not ask for such information) and calculated the programming fees that the system would incur for each tier 2 subscriber. That cost alone, assuming the program fees had been charged at "rate card", would have amounted to over \$2.70 per subscriber – substantially above the price being charged by the operator for the service. In practice, cable systems often obtain substantial discounts from a channel supplier's rate card. But even then, this case provides a clear example of a price that is unsustainable over the long run. Benchmarks reflecting price wars could clearly prevent cable systems from recovering their service costs, and the resulting regulation would provide no incentive to continue to supply cable service.

Competitive benchmarks should be developed from instances of enduring competition, in which the rival cable systems have moved beyond the price-war stage to reach a sustainable price equilibrium that allows each to recover its fixed as well as variable service costs. Price wars typically characterize the early few years of an overbuild situation. After that, either some form of consolidation of the two systems occurs or competition persists, but with each rival increasing its price to a sustainable level.

Evidence of this can be found in the FCC database. We re-estimated a modified version of the FCC equation, using only those cable systems involved in an overbuild situation, and we added a variable describing how long competition had persisted in each instance. I found that in franchises where the duration of competition was five years or less prices were 30% lower than in those franchises where competition had endured at least six years. The statistical reliability of this difference is extremely high, which means there is